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Early Encounters between CPAs and the SEC

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EARLY ENCOUNTERS BETWEEN CPAs AND THE SEC*

Abstract: The recollections of John L. Carey about the policies and politics in professional circles during the very important period when the Securities Exchange Commission first came into being. Mr. Carey served the American Institute of Certified Public Accountants in various capacities from 1925 to 1969, including editor of *The Journal of Accountancy* and Administrative Vice-president, and received the Institute's gold medal for distinguished service to the profession.

The stock market crash of 1929 ruined many investors, large and small. Thousands of people who had bought stocks on margin during the "New Era" boom of the late 1920's were completely wiped out. Some men who had thought they were wealthy jumped out of windows.

An angry public turned its wrath on the stock exchanges, the investment bankers, the corporations whose stocks had lost much of their value, and to some extent the accountants who had audited the financial statements of those corporations. However, the accounting profession had a lower profile then than now. Only the more knowledgeable observers were aware of the auditors' role, so they were not as visible a target as others. This dubious advantage was not to last long.

The Senate Committee on Banking and Currency launched an investigation of the securities markets, with Ferdinand Pecora, a tough lawyer, as committee counsel. The findings were to result in the Securities Acts of 1933 and 1934.

In 1932 two events fanned the flames. The international empire of Kreuger and Toll collapsed when its head, Ivar Kreuger, known as the "Swedish match king", committed suicide. It was found that he had falsified accounts, forged documents, and concealed misappropriation of funds on a massive scale. American investors in his companies lost heavily, and questions were raised about audits of the financial statements. American accountants who had any connec-

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tion with Kreuger and Toll subsidiaries were called upon to testify, but since the frauds had occurred in Sweden, where no American accountants had access to the records, they were not held responsible. However, doubts had been raised about the effectiveness of financial reporting and independent audits in general.

Also in 1932, a book was published which had great impact in sophisticated circles, and further encouraged demand for legislation regulating the issuance of securities and financial reporting of the issuers. This book was *The Modern Corporation and Private Property*, by Adolf A. Berle, Jr. and Gardiner C. Means, published under the auspices of the Columbia University Council for Research in the Social Sciences, acting on behalf of the Social Science Research Council of America. So far as I know this was the first scholarly and authoritative analysis of the modern corporation in America and its relation to stockholders and investors. Its main thrust seems hardly novel today, but it was news to many people then: that ownership and management were almost completely separated; that management almost completely controlled the corporation's affairs; that stockholders as a whole had little voice; and that the information available to stockholders was often inadequate to permit sound judgment of the risks they were assuming.

This naturally led the authors to discussion of corporate financial reports and independent audits. In the preface credit was given to Professor William Z. Ripley, "who must be recognized as having pioneered this area". Professor Ripley's criticisms of the accounting profession in the mid-1920's had been responded to by George O. May at the American Institute's 1926 annual meeting.

In 1932 George O. May had enjoyed some five years of freedom from administrative responsibilities as senior partner of Price Waterhouse & Co. He was consultant to the Committee on Stock List of the New York Stock Exchange, and chairman of the American Institute of Accountants' Committee on Cooperation With Stock Exchanges, which was working with the Exchange on the development of new standards of financial reporting.

Among Mr. May's acquaintances was the brilliant young Columbia University law professor, A. A. Berle, co-author of *The Modern Corporation and Private Property*. Somehow Mr. May must have learned that the book was being written, and found opportunity to talk with Berle before it was published. While Berle was highly critical of current accounting practices, the criticism was somewhat tempered by such interpolations as: "Accountants of the highest grade decline to certify to such statements . . ." and "Capable accountants of a high degree of integrity will catch these situations as they arise . . ." To me these modifications of an otherwise devastating indictment were clear evidence of George O. May's diplomatic influence.

Although Professor Berle seemed to be a somewhat opinionated, arrogant young man, his brilliance could not be questioned. A member of President Franklin D. Roosevelt's "brains trust", Berle was the principal author of *The Modern Corporation*, which later events suggested was almost a blueprint for the Securities Acts. So it was not of trifling importance to have him say in the book, "the integrity of the accountant and the soundness of his method are the greatest single safeguard to the public investor", even though the compliment was diluted by the comment, ". . . The failure of the law to recognize accounting standards is probably due to the lack of agreement among accountants. . . ."

My own acquaintance with Berle came about in this way. In the spring of 1933 the "Truth in Securities Act" became law. Berle's book, it could be assumed, had had some influence on the content of that law. Berle himself was an advisor to the President. It seemed to me that it would be a brilliant stroke of public relations to persuade him to speak at the annual meeting of the Institute to be held at New Orleans in the fall. I cannot recall clearly whether the idea originated with me or not, but I think it did. However, Mr. May could have suggested it, and in any event he must have approved it, and probably made the first approach to Mr. Berle.

As secretary of the Institute it fell to me to call on Professor Berle and present the formal invitation. He was thin, sharp-featured, unsmiling and unbending. However, after I made my little speech, alluding to the interest in accounting manifested in his book, he accepted the invitation to address the Institute's annual meeting. I remember expressing the hope that he could take some time off, away from all the pressures on him, and enjoy a few days' relaxation in the attractive city of New Orleans after the meeting. He put me in my place by saying rather frostily that if he had time for a vacation he would take his family to some quiet spot without being involved in a convention.

Anyway, I was jubilant at the prospect of having so influential a personality address our meeting. His acceptance was highlighted in the announcements, and doubtless influenced many members to attend. But I was to experience the first of many disappointments of this kind — shortly before the meeting Professor Berle telephoned to say that he could not attend in person but would send his paper.

I pleaded with him not to disappoint the hundreds of accountants who expected to hear him, but he was adamant, and that was that.

His paper, "Public Interest in Accounting," was read at the meeting by Walter A. Staub of New York. The paper did not evoke much applause. It stated that accounting was ceasing to be in any sense a private matter; it questioned a number of specific accounting practices; and it called for the consistent development of accounting principles subject to the test of public interest. Then in the paper Professor Berle questioned whether such principles could be developed by accountants alone — whether individual accountants could maintain completely impartial minds when under the "instructions" of a client. He predicted that a government bureau would be set up to standardize accounting practices in various industries.

At the meeting Walter Staub was asked to read Berle's paper. Having dutifully done so, Mr. Staub opened the discussion by strongly challenging the author's assumptions and conclusion. Staub, a key partner of Lybrand, Ross Bros. & Montgomery was an extremely competent and influential man. He was an assiduous student of accounting and all that pertained to it. In his remarks, he pointed out the failure of government control of the accounting of railroads, utilities and banks. He cited the progress the profession had already made, and was making, in cooperation with the New York Stock Exchange and bankers, toward elimination of accounting practices which Berle had criticized. Then Staub almost angrily rejected Berle's patronizing doubts about the independence and impartiality of public accountants.

Mr. Staub's remarks were warmly applauded, and were followed by discussion from the floor. The audience sensed that control of accounting by government was nearer than ever before. The Securities Act had become law only a few months earlier. It gave a government agency power to prescribe the form and content of financial statements, and the methods to be followed in the preparation of accounts. Among those at the New Orleans meeting anxiety was mingled with resentment at Berle's too facile criticisms, and Staub's strong defense of the profession was a welcome rallying cry.

Unfortunately, as I thought then and still do, this exchange of views had little or no public exposure. So far as I remember, the press was either unaware of the incident or paid it little attention. Reporters were not in the habit of covering accountants' meetings, and the general public showed no interest in accounting at all. It was customary to publish in *The Journal of Accountancy* the papers presented at annual meetings, but in this case the powers that be decided not to give Berle's views that much circulation. I ventured to suggest that both his paper and Staub's rebuttal be published, but to no avail. I was not the editor of *The Journal*, I had been secretary of the Institute for only two or three years, and I had not reached my thirtieth birthday, so my judgment on matters of high policy did not weigh heavily! What I had dreamed of as a major public-relations coup turned out, to mix a metaphor, as a lead balloon.

In January, 1934, only a few months after the meeting at New Orleans, the Institute published "Audits of Corporate Accounts," a pamphlet containing the historic correspondence between the Institute committee headed by George O. May and the Committee on Stock List of the New York Exchange, staffed by J. M. B. Hoxsey. The negotiations leading to this publication had begun in 1930, as recounted in the second paper of this series.

"Audits of Corporate Accounts" clarified the responsibilities of independent auditors: established the concepts of generally accepted accounting principles and consistency in their application from year to year; and proposed the first standard form of auditor's report, which was immediately adopted and has survived with some changes to the present day.

The Securities Acts of 1933 and 1934

The events just described coincided roughly with the enactment of the Securities Act of 1933, the Securities Exchange Act of 1934, and the creation of the Securities and Exchange Commission to administer them both.

The 1933 Act was one of the first major reforms of the "New Deal" launched by Franklin D. Roosevelt, who had been inaugurated as President only a few months before this law took effect. The findings of the so-called Pecora investigation provided background information for the legislative draftsmen.

While the bills were pending before Congressional committee the Institute made some recommendations informally "through various channels . . . to persons influential in the administration and in Congress." But the only certified public accountant to speak on the proposed legislation was Arthur H. Carter, then president of the New York State Society of Certified Public Accountants. He appeared before the Senate Committee on Banking and Currency to advocate inclusion in the new law of a requirement that the accounts of registered corporations be audited by independent accountants.

The fact that he took this step without consultation with the Institute pointed up some of the flaws in the profession's organizaional structure, and in personal relations among some of its prominent members. There were two national organizations — the Institute and the American Society of Certified Public Accountants, of about equal size. Almost as large as each of them was the oldest state society, the New York State Society, most of whose members belonged to neither national group. Partly because of this, and partly because of its position astride the nation's financial center, this state society considered itself independently competent to deal with national legislation affecting the profession, as well as local affairs.

Colonel Arthur H. Carter, then president of the New York State Society, encouraged this attitude, partly, perhaps, because he had not been made to feel an intimate member of the Institute's inner circle. Colonel Carter was a relatively recent arrival among the heads of the large accounting firms. He was a West Point graduate, formerly a regular army officer, and author of a book on artillery tactics which had attracted favorable attention in military circles. He married the daughter of Elijah Watt Sells, one of the two founders of Haskins & Sells. In 1919, after World War I, Colonel Carter joined that firm and passed the CPA examination. In 1930 he became managing partner of Haskins & Sells.

He was a handsome man, of military bearing, with a flashing smile and attractive personality. However, the habit of command apparently kept some colleagues at a distance. John Forbes, who had been partner in charge of all Haskins & Sells west coast practice, told me that Colonel Carter was a brilliant man, but just didn't understand the partnership relation. Mr. Forbes resigned from Haskins & Sells, and then in 1932 became president of the Institute. This may not have enhanced the Colonel's affection for the organization.

Then again, there was some feeling of rivalry between the large firms of purely American origin — Haskins & Sells and Lybrand, Ross Bros. & Montgomery — and those of British origin, many of whose partners in America had come from England and Scotland — Price Waterhouse & Co., Peat, Marwick, Mitchell & Co., and Barrow, Wade, Guthrie & Co., for example. Since George May of Price Waterhouse was highly influential in the Institute, Colonel Carter may have been moved to demonstrate via his office in the New York State Society that native American accountants were capable of providing leadership.

In any case, he testified before the Senate Committee. It was not a kindly audience. The questions and comments revealed an astonishing ignorance on the part of some senators regarding the nature of independent audits. One senator seemed to suspect that the witness was seeking additional employment for certified accountants. Questions ranged from how much audits would cost, to why corporation controllers needed to have their work reviewed, to why the government should not perform the audits if they were necessary. One senator asked bluntly, "Who audits you?" Colonel Carter's inspired reply, "Our conscience," has been quoted more than once.

In any event the Securities Act of 1933, as enacted, gave the administrative agency authority to require independent audits.

The first reaction was appointment of an Institute committee on cooperation with the SEC. This committee, accompanied by the Institute's secretary (me), promptly waited upon Joseph P. Kennedy, the Commission's first chairman. Mr. Kennedy was cordial enough. He welcomed the offer of cooperation in developing regulations essential to administration of the accounting and auditing provisions of the new securities laws. However, he didn't stay on the job very long. He was appointed Ambassador to Great Britain, and was succeeded by James M. Landis, who, if memory serves me right, was a former dean of Harvard Law School, briefly a member of the Federal Trade Commission (which first administered the 1933 Act), and then a member of the SEC.

Another member of the new SEC was George C. Matthews, who, as I recall, had been a member of either the Wisconsin Public Utility Commission or the Tax Commission. He knew more about accounting, albeit from a specialized, regulatory point of view, than most of his colleagues. He was also a reasonable, moderate man, who was willing to listen.

However, Mr. Landis was not so easy to deal with. Cordial and conciliatory at first, he became increasingly critical of the accounting profession. He was a thin, tense, somewhat impatient man, almost humorless, and clearly feeling the pressure of his new responsibilities.

The Institute Committee on Cooperation With the SEC worked very hard. There were many meetings in Washington with staff and members of the Commission, most of which I attended. Much of the discussion of technical matters was over my head, but it was clear that the Institute representatives had a big job of education to do. Most of the commissioners and top staff were lawyers or economists, with less than a perfect understanding of accounting and auditing. In developing policies and regulations covering these areas some SEC officials were tempted to write a rule book establishing uniform accounting for corporations subject to their jurisdiction. The Institute committee kept pointing out the hazards of such an approach.

The publication in 1934 of "Audits of Corporate Accounts" strengthened our committee's contention that the profession could do the job of developing accepted accounting principles.

The commission had soon realized that it needed a full-time senior staff assistant who was a qualified professional accountant. By a stroke of good fortune Carman G. Blough was appointed to the newly created post of Chief Accountant of the SEC. He had served in the new Commission as security analyst and as assistant director of the registration division. He was a CPA of two states, a former member of the Wisconsin State Board of Accountancy, a former accounting professor and head of the accounting department at the University of North Dakota, member of the Wisconsin Tax Commission, and secretary of the Wisconsin State Board of Public Affairs. Blough was not only a competent accountant but was temperamentally ideally qualified for the new job. The ablest practitioners who dealt with the Commission soon came to respect and like him. Perhaps more importantly, the commissioners themselves soon came to rely on him heavily for decisions on accounting and auditing matters.

The critical importance of having such a man in the powerful office of Chief Accountant of the SEC was soon to be demonstrated.

Chairman Landis, who always seemed to be harassed, his patience strained, could blow hot and cold. In January, 1935, speaking before the New York State Society, he praised the CPA organizations for their help and cooperation and invited their criticism and questions — "We need you as you need us." In October, 1935, speaking before the American Management Association, he referred to the accountants in a way that suggested they were helpful collaborators. But in December, 1936, in a speech to the Investment Bankers Associations, he delivered this wintry blast:

> The impact of almost daily tilts with accountants, some of them called leaders in their professions, often leaves little doubt that their loyalties to management are stronger than their sense of responsibility to the investor. . . .The choice here of more or less regulation is an open one for the profession. It is a 'Hobson's choice' for government.

This threat, without prior warning, was a shock. The chairman of the Institute Committee on Cooperation With SEC telephoned Mr. Landis to express concern. Mr. Landis, tired perhaps, was not belligerent. He indicated a desire to be helpful, and suggested consultation with the Commission's chief accountant. The result was an arrangement whereby Carman Blough could consult the Institute committee on questions involved in disagreements between the commission's staff and accounting firms who had signed financial statements filed with the SEC.

This blossomed into almost continuous consultation, including frank informal discussions, between Carman and Institute representatives as well as individual partners of accounting firms. This give and take focused on specific cases involving problems of corporate financial reporting. Gradually a pragmatic, evolutionary approach to development of accounting principles was developing.

As the Commission's confidence in Carman's competence and judgment increased his recommendations became more and more influential. The SEC dropped the idea of issuing a rule book, for the time being at least, and offered the profession the opportunity to take the lead in improving the situation, while reserving the SEC's right to exercise its authority whenever it seemed desirable to do so.

Meanwhile, the profession had made some tentative steps toward establishing formal, authoritative guidelines governing corporate financial reporting, and the effort was soon to be beefed up substantially. But that is a subject for another paper.